FRBSF Weekly Letter

January 10, 1986

"Soft-Landing" vs "Hard Fall"

When the U.S. dollar reached dizzying heights last February in a climb that began in 1980, many were concerned about its detrimental effects on the U.S. economy. Since then, the dollar's value has taken a 24 percent fall on a trade-weighted basis against other major currencies. Some now worry about the shock of such a "hard fall," and wonder if a more gradual, "soft landing" might not be more beneficial to the U.S. and world economies.

"Soft landing" and "hard fall" are, of course, relative terms. In this *Letter,* "soft landing" is defined as a fall of about 5 percent a year, and "hard fall" as a decline of more than 10 percent a year. To a large extent, the choice of the starting point for a fall also is arbitrary. For the purpose of this *Letter,* the benchmark for measuring exchange rate changes is the average value of the dollar during the fourth quarter of 1984. At that time the dollar's value was 10 percent below the February 1985 peak and 6 percent above the average level for the whole of 1984.

Against that benchmark, the dollar had fallen about 5 percent on a trade-weighted basis against other major currencies by September 20. This drop translates to an annual 6.7 percent depreciation rate, which exceeds only moderately our definition of a "soft landing." September 20 was the eve of a meeting of the Group of Five finance ministers and central bank governors — representing France, West Germany, Japan, the United Kingdom, and the United States — at which the nations agreed to start coordinated interventions in the exchange market (See this *Letter,* December 13, 1985). Since then, the dollar has fallen further, such that by late December, it was 15 percent below the fourth quarter, 1984 benchmark. This depreciation rate qualifies as a "hard fall."

This *Letter* explores the reasons behind the dissatisfaction with a "soft landing" of the dollar and the more recent concerns over the effects of a "hard fall." The analysis indicates that it is not the "razor's edge" situation suggested by popular concerns. Although a "hard fall" is shown to be clearly preferable, the analysis does not support a deliberately expansionary monetary policy for accelerating the dollar's decline.

Soft landing

Simply stated, dissatisfaction with a "soft landing" of the dollar stemmed from a concern that it would not produce sufficiently rapid economic adjustments to reduce the U.S. trade deficit. From $36 billion in 1980, the deficit increased sharply to $123 billion in 1984 and deteriorated still further in 1985. A major factor behind the deterioration has been the steady dollar appreciation from 1980 to February 1985, with several particularly disturbing potential consequences.

First, there is concern that unless the dollar falls rapidly, the United States will soon become the largest debtor nation the world has ever seen. Assuming an annual dollar depreciation rate of 4 or 5 percent, estimates suggest that it would take ten to fourteen years to eliminate the U.S. trade deficit, resulting in a cumulative increase of U.S. net foreign debt amounting to $1.5-2.3 trillion by the year 2000. It is doubtful if foreigners would be willing to accumulate such a large amount of dollar assets in their portfolios; and, even if they were, there is some question as to whether it would be in the U.S. interest to carry such a heavy foreign debt burden into the future.

Second, the large and growing trade deficit has imposed a highly uneven distribution of the burden among the industrial sectors of the national economy. It has taken a particularly heavy toll on agriculture, forestry products, mining, and a wide spectrum of manufacturing industries that are dependent on overseas markets or that compete actively with imports.

Third, a more immediate threat has been a rising tide of protectionism in the United States, manifested in the numerous bills in Congress that would erect trade barriers on a wide spectrum of commodity imports. The bills, if enacted, would incur the risk of worldwide retaliation against U.S. exports, as occurred in the 1930s. By the time of the Group of Five meeting in September this year,

it had become clear that nothing short of a rapid fall of the dollar could stem the protectionist tide and avert the threat of a disastrous trade war.

Hard fall

As stated, the dollar's depreciation in 1985 has qualified as a "hard fall". Should we worry about its consequences?

One fear has been that a "hard fall" of the dollar might cause investors to lose confidence in the dollar and withdraw from dollar assets. A massive withdrawal from dollar assets might result in a sharp rise in U.S. interest rates, which, in turn, might reduce investment and consumer demands and possibly precipitate a U.S. recession.

So far, fear of such a sequence of events has not been justified. Had there been a massive loss of confidence in the U.S. dollar, the dollar depreciation would have been accompanied by a rise in U.S. interest rates as investors demanded higher premia for retaining dollar assets. In fact, U.S. interest rates have *declined* in 1985 both absolutely and in relation to interest rates in major foreign countries.

Nevertheless, the concern over the potential effects of a loss of confidence in the dollar needs to be addressed. The absence of such a loss of confidence thus far does not preclude its future occurrence. Should it come about, would the resultant rise in interest rates cause a serious decline in U.S. aggregate demand?

Aggregate demand

The answer must depend in part on how far interest rates would rise. A loss of confidence in the dollar may be viewed as an increase in the risk premia for holding dollar assets. However, it is wrong to think that U.S. interest rates must rise fully to offset the increase in risk premia. To the extent that the fund withdrawal does not reflect a change in fundamental market conditions, the concomitant dollar depreciation renders foreign currency assets more expensive in U.S. dollars and, hence, less attractive to acquire. Moreover, insofar as dollar assets are viewed by a sufficiently large group of investors as close substitutes for foreign currency assets, a small rise in U.S. interest rates should suffice to induce investors to retain dollar assets.

In short, a fund withdrawal creates in its own process two price adjustments: a rise in U.S. interest rates and a fall in the exchange value of the dollar, both of which work to reduce the incentive to shift out of dollar assets. In general, the larger the dollar depreciation, the smaller U.S. interest rates would need to rise.

In view of the huge size of the world dollar asset market relative to that of the dollar exchange market, it seems that, for a given amount of fund withdrawal, U.S. interest rates would rise relatively little, whereas the exchange value of the dollar would depreciate a lot. In other words, one might expect that most of the shock of an intended fund withdrawal would be absorbed by dollar depreciations and relatively little by increases in U.S. interest rates.

How U.S. aggregate demand would be affected also depends on the magnitude of the expansionary effects of dollar depreciations relative to that of the opposing impact of interest rate rises. Economic theory suggests that given a high degree of capital mobility, which is apparently the case for the United States, the expansionary effects of dollar depreciations following a capital outflow would tend to dominate the contractionary impact of higher interest rates. The net effect, therefore, should be a *rise,* not a *fall,* in U.S. aggregate demand. Model simulations have tended to support this view. Thus, on both theoretical and empirical grounds, there is little reason to believe that a loss of confidence in the dollar would lead to a serious decline in U.S. aggregate demand.

Inflationary impact

The second concern over a "hard fall" of the dollar has to do with its potential impact on domestic inflation. The large dollar depreciation in 1985 is likely to raise the U.S. prices of imports and, indirectly, the prices of U.S. goods that compete with imports in 1986 and beyond. How large and how longlasting the total effect on the U.S. price level will be is an empirical question. A recent study suggests that a 10 percent dollar depreciation in 1985 would raise the U.S. consumer price inflation rate by 0.7 percentage points in 1986, by an additional 0.3 percentage points in 1987, and have no impact from 1988 on.

On the basis of these estimates, the 15 percent de-

preciation in 1985 might raise the inflation rate by a full percentage point in 1986, an additional 0.5 percentage points in 1987, but no further afterwards. Thus, without monetary accommodation, the total effect of the dollar's "hard fall" in 1985 would be some stepwise increase in the U.S. domestic price level over the next two years, but not a continuing surge of inflationary pressure.

Another recent study finds that the impact of exchange rate changes on the domestic inflation rate depends critically on how foreign exporters react to the exchange rate changes, which, in turn, depends on U.S. domestic aggregate demand conditions. For instance, during the vigorous U.S. economic recovery in 1982-84, when U.S. import demand was extraordinarily strong, foreign exporters were able to enlarge their profit margins by raising their export prices, thus completely offsetting any disinflationary effect the strong dollar appreciation had on the U.S. price level.

This experience suggests that considerable profit margins now exist for foreign exporters to absorb any adverse impact of dollar depreciations by reducing their export prices — unless U.S. economic growth will be exceptionally strong in 1986. Barring that event, the inflationary effect of the dollar's "hard fall" in 1985 can be expected to be even more modest than is currently estimated.

World growth

A third concern with the dollar's "hard fall" involves its impact on world economic growth. A reduction in the U.S. trade deficit would mean a corresponding reduction in the rest of the world's trade surpluses. Of particular concern is the impact on debtor developing nations, which have been especially dependent on large trade surpluses with the United States to service external debts.

However, the grounds for concern in this area appear questionable. The dollar's "hard fall" has been measured against the currencies of the other major industrial countries, not against those of the developing countries. The latter could, and indeed did, depreciate their currencies either along with the dollar or even against the dollar in order to maintain or improve their trade competitiveness. The other industrial countries, in contrast, could compensate for the declines in their exports to the United States by adopting expansionary macroeconomic policies for stimulating domestic demand. The world economy would, in any case, be better off with more balanced economic growth among the industrial countries.

Conclusion

By the criteria used in this *Letter,* the dollar has taken a "hard fall" during 1985. This development is to be welcomed because an alternative "soft landing" would have meant the continued rapid accumulation of U.S. external debt, an unacceptably heavy toll on those sectors that are highly sensitive to foreign competition, and the serious risk of igniting a devastating resurgence of trade protectionism in the world economy.

Furthermore, concerns over the potential impact of the dollar's "hard fall" appear to be unwarranted at this juncture. Thus far, there is no evidence that the dollar's depreciation has led to a massive withdrawal of funds from dollar assets. Even if this should happen in the future, the expansionary effects of the ensuing dollar depreciation on U.S. aggregate demand are likely to more than offset the contractionary effects of interest rate rises. In addition, foreign authorities can compensate for any adverse effects on the world economy caused by the dollar's "hard fall." Finally, the inflationary impact next year of the "hard fall" is also expected to be modest, unless fueled by an overly accommodative monetary policy or excessively vigorous domestic economic expansion.

The last consideration suggests that although further "hard falls" of the dollar need not cause undue concern, a deliberately expansionary monetary policy to bring it about would be unwarranted. In contrast, if further "hard falls" result from shrinking U.S. budget deficits and declining U.S. interest rates relative to those abroad, the outcome should be felicitous from the viewpoint of correcting the U.S. trade imbalance and reducing the strains on the world economic and financial system — even at the cost of some temporary rises in the domestic price level.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/18/85	Change from 12/11/85	Change from 12/19/84 Dollar	Change from 12/19/84 Percent[7]
Loans, Leases and Investments[1] [2]	199,468	1,586	11,064	5.8
Loans and Leases[1] [6]	181,116	1,359	10,979	6.4
Commercial and Industrial	51,937	475	− 1,062	− 2.0
Real estate	66,062	153	4,143	6.6
Loans to Individuals	38,334	180	6,642	20.9
Leases	5,485	73	406	7.9
U.S. Treasury and Agency Securities[2]	10,740	15	− 618	− 5.4
Other Securities[2]	7,612	212	704	10.1
Total Deposits	202,708	− 276	8,280	4.2
Demand Deposits	51,027	282	4,719	10.1
Demand Deposits Adjusted[3]	33,762	− 578	4,201	14.2
Other Transaction Balances[4]	14,572	− 113	1,934	15.3
Total Non-Transaction Balances[6]	137,109	− 445	1,626	1.2
Money Market Deposit Accounts—Total	45,888	− 15	4,768	11.5
Time Deposits in Amounts of $100,000 or more	37,794	− 328	− 3,331	− 8.0
Other Liabilities for Borrowed Money[5]	26,433	2,662	3,973	17.6

Two Week Averages of Daily Figures	Period ended 12/16/85	Period ended 12/2/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	56	68
Borrowings	44	148
Net free reserves (+)/Net borrowed(−)	12	− 79

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately
[7] Annualized percent change